

TRANSITION IN EASTERN EUROPE

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The relatively bloodless economic and political collapse of the former Soviet bloc has been surprising in many respects. The political disaster of the communist empire was deep and spread rapidly to a large number of countries; but it came rather unexpectedly. Post-communist leaders made frequent public statements about their commitment to free-market principles, but transition towards the free-market model kept encountering impediments. Recommendations and suggestions for policy-making have been offered in great quantity by scholars as well as by development experts at think tanks and international agencies, but their policies have produced disappointing results. More generally, despite the huge literature which has been flourishing since the early 1990s, the origins and unfolding of transition remain unclear, and most of the proposed solutions to the economic problems related to "transition" continue to be debated.

Part of the problem may be due to the fact that the collapse of the communist empire was not a traditional political crisis. The incumbent rulers were not voted out of power, as in a democracy. But it is also hard to claim that some kind of popular revolt against the communist leaders occurred. In fact, most of those very leaders are still in key positions today, often with substantial and diffused support. This is important, for it reveals some neglected and yet critical features of most Eastern-European transition countries in these years. In particular, these countries have not generated a new cohort of political leaders legitimized by their competence and technical expertise. Strong commitment to free-market economic principles has not been enough to gather consensus, and may even be counterproductive. And the reluctance to get rid of the old *élite* demonstrates that personal ties and informal institutional structures have remained of the greatest political importance. In many situations a deep involvement with past planning and political practices is still an asset, both for politicians and for managers, rather than a cause for shame and disgrace.

These points are of particular relevance for the law-and-economics interpretation of transition in Eastern Europe, which attributes particular importance to the origins of the crisis. The system of property-rights in a market-economy is the critical issue for understanding the nature of institutional change and the chances for successful transition towards a free-market model. More precisely, the appropriate assessment of the consensus - or lack of it - about the system of property-rights to be employed and about the process through which the new property-rights structure should be defined and monitored, and about the role of government in the process will determine the kind of transition an economy will experience.

This is clearly in contrast with the standard view, which takes for granted that the pattern of property rights emblematic of a planned economy have been rejected by the vast majority of the

population. The standard view also ignores the existence of a dense and very important network of informal economic arrangements, which were often much more effective than the formal institutional framework, and which in many cases have become stronger after the collapse of the communist regime. The failure to understand the continued importance of these informal economic arrangements has meant that the nature, direction and speed of the transition process has sometimes been grossly misunderstood. While it is impossible to ignore the very significant progress which has been taking place in some countries in less than five years (the example quoted most frequently is the Czech Republic) - a record of institutional change almost unparalleled in recent history, it is also fair to say that in most Eastern European countries transition is much slower than expected; that in some cases it has hardly started, or has led to chaos and wealth-destruction rather than wealth-creation (as in Belarus). And that everywhere - even in the Czech Republic - economies work in a way which is often at odds with what the formal institutional models would predict.

The orthodox explanation of such failures identifies voluntary or involuntary mistakes by the Eastern European decision-makers, the former being caused by short-term political and electoral constraints, the latter by failure to follow Western recommendations. Instead, the law-and-economics view focuses on the legitimacy, and thus on the limits, of the transition process and to the possibility of contrast between formal and informal institutions. Put differently, the fundamental shortcoming of the orthodox theories is that they are not really concerned with transition but rather with the methodology of transition (Winiński, 1992). By focusing on methodology, these approaches can clarify the economics of success and failure; but do not explain why transition has been easier in some countries than in others, why it has led to a wide variety of different results, and why in some countries the collapse of the communist regime has not improved economic performance, but instead has led more to an upsurge in criminal activities.

Under the traditional neo-classical account, a successful transition requires decentralized preferences and decision-making, and efficient relative prices. This in turn implies that property rights should be assigned to consumers and producers, who should then be free to maximize their objectives. The relative price structure should reflect scarcity; and monetary and fiscal illusions should be eliminated by balancing the government budget. This has been the basic recipe offered by Western orthodox economists. In a frictionless, zero transaction-cost world these measures are sure to produce growth and prosperity. Of course, one may argue about the speed and sequencing of the transition process. But in a neo-classical framework these are secondary consideration, because transaction costs have little influence on the features and depth of the transition process beyond the short run. Such costs are regarded as "sunk" in the sense that they will have to be incurred sooner or later in any case. These costs reflect the need to move resources from one industry to another, from inefficient to efficient firms, as well as the need to find new markets following some kind of comparative-advantage pattern. From this perspective, speed is relevant only because the dislocations associated with transition might

strengthen interest groups who oppose it, increasing the risk that the process will be stopped or even reversed. This is the basis for the neo-classical argument for a shock-therapy approach.

Gradualists generally share the long-run objectives of the neo-classicists, but favour a more gradual passage from planning to market, because they see the neo-classical approach as too painful. Gradualists want the transition process to be supervised by government intervention (soft planning) aimed at insuring that the move towards the new system does not produce high unemployment and unequitable distribution of income.

Unfortunately, the real world is not characterized by zero or frictional transaction costs, and the reality is that transition often generates a short-run drop in national income, as producers are sometimes slow to learn that satisfying consumer demand is more difficult than satisfying the central planner, or the Ministry of Defence (especially in the case of the Soviet Union), or the local *nomenklatura*. For instance, the percentages of the population living below the poverty line between 1989 and 1992 increased from 13% to 57% in Bulgaria, from 4% to 25% in the Czech Republic, from 14% to 20% in Hungary; while from 1989 until the mid-nineties GDP fell by 20-30% in East-Central Europe, and by 40%-60% in the remaining economies of the former Soviet bloc, including the Baltic States (Altmann, 1996). All this may be temporary, of course; but it can hardly be characterized as frictionless or smooth.

The law-and-economics approach differs from both the neo-classical and the gradualist approaches by focusing on the economics of the institutions involved, and utilizing public-choice theory to analyze the behaviour of governmental actors in the final period in the life of a command economy, when the existing system for allocating property-rights is no longer viable (Colombatto and Macey, 1997). The institutional approach to transition looks at history, because the historical structure of pre-existing institutions will determine, to a large extent, the structure of the institutions that emerge in transition. By contrast, the public choice perspective on transition focuses attention on the bargaining conditions that sometimes allow old interest groups to maintain power, and sometimes allow new groups to obtain new power at the expense of existing groups.

Under the public-choice approach, debates about shock therapy versus gradualism and even over the mechanics of transition are largely irrelevant. Change cannot be imposed by *fiat*; rather, the nature of transition will be determined by the relevant decision-makers within the population. In other words, according to the law-and-economics approach the various bits and pieces of a new institutional context fall into place following the bargaining process among the different interest groups. The outcome is not necessarily desirable, but exogenous pressure to affect the direction and/or the speed would delegitimize transition *per se*, and in fact bolster the old *élites*.

1. The Economics of Reform and Transition

1.1 Reform

The law-and-economics approach appears particularly useful in order to understand how the economics of transition differs from the economics of reform. The difference between transition and reform is important. Reforms simply alter the payoffs to the various factions within the ruling coalitions. Not surprisingly, even before the collapse of the bloc, the communist leadership in Soviet bloc countries at various times made substantial attempts to change some features of the system in order to produce more acceptable levels of growth. These so-called "reforms" inevitably failed because the countries being reformed remained command economies. The underlying systems of property-rights were never affected. The reforms simply altered the payoffs among the various factions within the ruling coalitions. Although the balance of power within the factions comprising these ruling coalitions, and indeed the composition and the legitimacy of the rulers themselves, sometimes changed, the basic structure of the system was never in doubt. And the ruling coalitions remained essentially intact. Consequently, the usual rent-seeking process within these countries was untouched. Put differently, reform efforts left existing property-rights assignments intact, and changed only the pattern of the payoffs from rent-seeking. Transactions costs for the economy as a whole remained high and information was very scarce. For example, prices and currency exchange rates remained tightly controlled; planning remained a code-name for the bargaining process among the central bureaucracy, the local bureaucracy, and managers. Consumers were excluded from the bargaining process, and there was no way for resources to go to their highly valuing users.

1.2 Transition

Traditional economic analysis is adequate to assess the quality of a reform programme, and the results it is likely to obtain, given the existing institutional framework. But law-and-economics provides superior tools to evaluate transition, which involves a drastic reduction in transaction and information costs, and a profound rationalization in the assignment of property rights.

The real question, however, relates to the variables which determine the very inception of the transition process. To a large extent, the law-and-economics approach looks to the public-choice equilibrium in place in a particular country at the moment the transition process begins, to determine whether transition will be successful.

In general, transition will be initiated either from above, i.e. by easy-to-identify interest groups; or from below, i.e. by the public at large. This is often a critical difference in assessing the probability of success of a transition process. Transition from above is successful only in the rather unlikely cases in which new coalitions draw their legitimacy to power through an explicit commitment to growth and to

more efficient property-rights assignments. Constitutional law-making will then aim at increasing the transaction costs of rent-seeking; it will enhance information flow and reduce the cost of entry (and exit) into (from) the political arena.

When coming from below, pressure for change always favours higher levels of income and prosperity in the population as a whole, but such pressure may not be enough to solve the contractual problems among interest groups that impede institutional innovation. If public pressure for improved economic performance is coupled with general acceptance of new criteria for the assignment of property-rights, transition stands a good probability of success. But a mere desire by the public at large for better economic performance cannot overcome an inability to abandon a pre-existing system for allocating property rights. In such cases, attempts to change pre-existing legal structures through constitutional law-making come to resemble ordinary law-making. Where this happens the cost of rent-seeking may actually decline in the name of reform. This increases uncertainty and leads to economic decline. Chaos tends to be the ultimate outcome (Colombatto and Macey, 1994).

2. Eastern Europe according to law-and economics

2.1 The collapse and transition of the Soviet economy

In the period following World War II, the economics and the politics of every country in Eastern Europe was dominated by the Soviet Union. Not surprisingly, the collapse of the former USSR triggered the start of the transition process in Eastern Europe.

There is a political as well as an economic explanation for the peaceful disintegration of the Soviet command economy. The Stalinist "war-economy" model provides the common background for both of these explanations. During the war, autocrats were legitimized by the danger of capitalist aggression and the economy was designed and operated to maintain the necessary strength to win an armed conflict. Personal and ideological loyalty were the qualities in demand. Technological requirements were relatively limited, and the task of the bureaucracy was to transmit orders from Stalin's ministers to the firms. The army was the only interest group in a position to challenge the autocrat.

As noted in Naishul (1991), the beginning of *détente* coincided with a period of technological advancement that, in turn, changed the sources of legitimacy and the balance of power within the coalition of interest groups ruling the country. In order to keep the economy from collapsing, in the early 1960s the Communist Party oligarchy had to yield authority to bureaucrats, who were in turn obliged to comply with the nomenklatura system, i.e. *the right of the Communist Party apparatus [...] to "recommend and approve" appointments for all managerial positions in economic (and public) administration, and managerial positions in enterprises* (Winiecki (1991), p.4 italics in original). The ultimate goal of this wave of reforms was apparent during the Brezhnev period, when it became clear

that the earlier top-down planning procedure had been replaced by an iterative planning process within the bureaucracy. But, of course, the command-economy pattern, including the state monopoly on the allocation of capital for new and existing businesses, remained in place.

According to the "politics first" explanation, crisis in the late 1980s broke out when President Gorbachev questioned the legitimacy of the power wielded by bureaucrats and of the top managers of the large firms. This attack on these entrenched groups was partially successful in leading to reforms that reduced rent-seeking by bureaucrats. But the bureaucrats were actually running the economy. Production was therefore disrupted and economic performance worsened considerably when the reduction in rents lowered bureaucrats' incentives to work and nobody stepped in to make the decisions previously made by bureaucrats. In other words, the formal institutional framework had been replaced over the years by an informal but effective bargaining system. By destroying the bureaucrats who were playing the key role in such a system, the existing institutional framework deteriorated even further.

The "economic" explanation differs in that it links the origins of the Soviet crisis to the deficient performance of the economy, especially in the two decades immediately preceding the collapse. Gradually, as technological developments drove down the costs of acquiring information about events in the outside world, the Soviet population would no longer accept sacrifices for the sake of security and ideology. This created strong tensions between the rent-seeking goals of the major interest groups on the one hand, and the need to reduce transaction costs and deadweight losses to satisfy the general population on the other. In the 1950s and 1960s such tensions were alleviated by modest growth and by informal institutional arrangements that made the inefficiencies of command planning less salient. But by the 1980s opportunities for extensive growth under the existing system were exhausted. The ruling *élite* was then forced to abandon the command-economy pattern and to advocate institutional change in order to have a chance to retain power in the future.

Under both the political and the economic explanations, transition started as a result of a political breakdown. The major difference between the two accounts concerns the ultimate cause of the collapse of the command economy - either a struggle within the ruling coalition (Party against bureaucracy and top managers), or economic failure, which in turn delegitimized the Party as traditionally understood.

The two theories also differ in their predictions. If the politics-first explanation is correct and the collapse of the command-economy was merely an unintended by-product of an internal political struggle between rival factions within the ruling coalition, then transition in Russia is unlikely to succeed in improving the economy in the near future. On the other hand, if the centralized property-rights pattern lost its appeal because ideological commitment would no longer compensate for low living standards, then transition will succeed in producing growth because the "new" politicians will only be acceptable to the public as long as they are committed to growth-enhancing constitutional change.

In fact, the abruptness with which the Soviet economic system broke down seems to indicate that at the beginning there was popular support for a new wave of reforms. The bureaucracy appears to have been singled out as the scapegoat for the economic failures of the past. Hardly anybody was really thinking about transition as such, that is, about changing the criteria for assigning property-rights. A reform programme went through, but led to chaos. Transition started in earnest much later, in the mid-1990s, when the weakness of the property-rights assignments generated by the current institutional vacuum induced politicians to claim power by promising the median voter neither ideological purity nor military might, but economic growth as the end of chaos. The credibility of such a claim is crucial in assessing whether transition really is now finally under way, or whether the institutional vacuum left by economic crisis and ill-designed reforms is going to be the arena where old and new interest groups come together to form effective, long-lived coalitions, fighting not for growth, but for power.

2.2 *Transition in the satellite countries*

In contrast to the situation in Russia, the old ruling *élites* in the countries of Eastern Europe derived their legitimacy from the very credible threat of Soviet military occupation, should the command-economy property-rights allocation be altered. Clear evidence of this is found in the fact that every state in the region experienced bloodless attempts to change their respective systems shortly after President Gorbachev announced that Russian troops would no longer interfere with domestic politics and policy making in the satellite countries.

Of course, this does not mean that the newly available practical possibility of dropping central planning implied *per se* a common desire to carry out transition. As a matter of fact, the countries of Eastern Europe followed different patterns of institutional change, each of them corresponding to the attitudes of dominant interest groups towards the transition process.

It seems fair to say that transition has been accomplished nowhere. Even in those countries which are singled out as examples for the area - the Czech Republic, Slovenia, and also Poland and Hungary, at a distance - the rules of the game have indeed changed significantly, but the informal structures and the old-style policies have not been abandoned entirely. Indirect controls by the government are still widely diffused and highly effective.

Nevertheless, it is fairly clear that in these countries transition has come from below. Structural features such as proximity to Germany, better trade relations with the OECD area, widespread familiarity with Western consumption patterns and culture surely also played an important role. The ensuing implicit contract between the *élites* and the population was clearly aimed at obtaining political independence and fast economic growth. That was the source of legitimacy for the new politicians, who could also belong to the previous ruling groups, as long as they could claim competence and credible commitment. The ability of post-Soviet ruling *élites* to engage in rent-seeking in these relatively successful countries was therefore limited. Poor performance would have deprived them of

legitimacy.

Something similar also occurred in a less successful set of countries, such as Slovakia, the Baltic States, and several Asian Republics, where the sources of legitimacy for the ruling class were more ambiguous. Pressure for growth was not as high as in other parts of the communist bloc, and the preferences of the public were ambiguous. In some situations the military problem did not dissolve immediately, due to the presence of strong Russian minorities and/or of nuclear arsenals claimed by the Russian government. Moreover, because voters feared that transition towards a free-market pattern might affect the existing informal and rather satisfactory institutional setting, the desire of the public-at-large to decentralize decision-making in production remained relatively weak. In fact such informal frameworks in these countries - where distance from the centre and ethnic ties probably played a major role - were probably faring much better than in other areas of the Soviet bloc, and the opportunities offered by an enhanced allocation of resources were partly frustrated by the poor skills of the labour force (Dallago, 1997).

As a result, transition in these economies has been relatively slow. In their own way, they are following a process of piecemeal engineering, starting from an obviously undesirable situation. Constitutional law-making has been looked upon with scepticism; utopian social engineering has been set aside. Caution prevails. Little by little, change in the formal property-rights system will reflect adaptation to the informal institutional framework, culture, and religion, lagging behind rather than leading. It will probably be faster in small and geographically more exposed countries, such as the Baltic states. It may be troubled in other areas, especially if certain ruling coalitions succeed in adopting a predatory strategy by taking advantage of the persisting ambiguities to become stronger, and extract rents.

2.3 *Transition in chains*

But there are also countries like Belarus, the Ukraine, Bulgaria, and Rumania, where transition never took off. These are situations where the regime collapsed because its inefficiencies could no longer be compensated by the Soviet Union, which was unable to transfer enough resources to allow people to survive. In one case (Rumania) politics played a role, too - as the autocrat suddenly lost legitimacy when he was no longer needed to oppose a Soviet invasion. In general, incumbent policy makers found themselves without the only major interest group supporting them - Moscow's ruling *élite*.

In these countries, the collapse of the very clear property-rights assignments that existed during the era of Soviet domination did not give way to a new property-rights structure, or to a consistent drive towards it; but rather to a power vacuum. The downfall of the Soviet empire often started a fight for power among would-be autocrats. But the bases of the predatory state were never seriously questioned. The end of the command economy was little more than an accidental casualty of infighting among pre-existing *élites*. In this framework it is therefore to be expected that the rulers tend to behave

as myopic bandits, who realize that they can be turned out of power any moment by other equally short-sighted bandits.

The outlook for the future therefore remains gloomy, unless a major shock occurs, and a new *élite* legitimized from below or with enough power to expect a long-term rule emerges - the beginning of a state based on some elements of contract.

3. Concluding remarks

The collapse of the command economies of the Soviet bloc has offered a striking opportunity to observe the implications of mainstream economics and to compare them with those of the law-and-economics approach. By and large, within the neoclassical framework, the role of the economist is at best confined to fine tuning (timing and sequencing), to the economics of credibility, and to some technical issues concerning the mechanics of privatization. Transactions costs play a marginal role within the traditional neoclassical framework. Economic failure is usually blamed on an unexplained failure to implement free-market reforms.

On the other hand, the law-and-economics approach emphasizes the origins of the Communist collapse, so as to understand the sources of legitimacy of the new rulers, their goals, and thus their ability to keep rent-seeking at bay and reduce transaction costs through appropriate constitutional change. As explained in Pejovich (1995) spontaneous institutional change becomes the very essence of the transition process. The analysis of how to run the utopian economy is of less interest, and the ability to create a suitable institutional framework produces the real challenge. Hence, informed scenarios about future developments can be put forward.

In other words, the traditional view takes the structure of existing institutions for granted. These institutions are thought to be the products of social engineering. In this context, failures in transition remain a matter of bad politics. By contrast, the law-and-economics approach considers the structure of existing institutions to be the outcome of a political process that is itself, motivated by the rational choices of interest group coalitions. Widespread dislike of the preexisting system is enough to destroy an existing regime, but is not enough to create an improved system for assigning property rights. In Russia, for instance, once bureaucratic planning was beaten, the bureaucracy remained as an extremely powerful interest group. To this day, bureaucrats or former bureaucrats remain in control of industry, have fairly easy access to various forms of subsidy, and can avoid paying taxes. Not surprisingly, these bureaucrats are unwilling to lend support to constitutional proposals that reduce their rent-seeking opportunities significantly. The policy choices made by these groups - including choices about the structure of institutions, and the level of protection for property rights - are structured so as to increase these groups' chances for survival. The success of transition depends, in turn, on the nature of these choices.

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